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SUBJECT: UKRAINIAN HRYVNIA IN FREEFALL AS NBU BOTCHES POLICY RESPONSE

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¶1. (SBU) Summary. A casualty of the worsening financial crisis, Ukraine's currency has lost another 12 percent of its value in recent days. Following an interim visit by the IMF to monitor GOU progress in implementing the $16.4 billion Stand-By Arrangement (SBA), the National Bank of Ukraine (NBU) has again boosted bank liquidity contrary to common economic principles and reverted to non-transparent foreign exchange interventions below market rates. Its reputation as a policy arbiter has been severely damaged, while Ukraine's national economic outlook looks gloomier by the day. End summary.

¶2. (U) The UAH plummet has accelerated in mid-December, with depreciation against the dollar drawing the interbank rate down to 9.90 UAH/$1 on December 19. The precipitous decline is leading to more one-way bets against the hryvnia at both the retail level and on the interbank market. Since late September, when Ukraine's economic crisis was first broadly diagnosed, the hryvnia has lost over half its value.

¶3. (SBU) The most recent slide took place despite low trading volumes on the inter-bank currency market. In the face of growing payment arrears and mounting debts, exporters still holding foreign exchange appear to be trying to hold off selling dollars as long as possible. Most are betting that volatile prices and limited dollar availability will continue to push the hryvnia downward. At the same time, the shrunken dollar supply has collided with sharply increased dollar demand. Reportedly, energy monopoly Naftohaz has been purchasing dollars as well, possibly in an attempt to settle at least part of its outstanding gas debt to Gazprom.

¶4. (SBU) Deeper reasons for the UAH slide reflect the manifold challenges that must still be overcome before Ukraine's currency stabilizes. Most glaringly, the National Bank of Ukraine continues to lose confidence as a result of its non-transparent and inconsistent attempts to intervene in the foreign exchange market. This week's currency slide began after the NBU pumped more liquidity into the money market. A similar slide in the hryvnia occurred in November after the NBU increased bank liquidity. In both cases, the liquidity, far in excess of what the banking system needed, flowed straight into dollars, further depressing the hryvnia rate. The IMF, in its latest visit to Ukraine last week, criticized the NBU actions in November, arguing that the NBU needed to tighten liquidity in order to support the hryvnia, and it left the country thinking that it had NBU assurances for the same. However, the NBU reverted to its former practices after the IMF departed, providing significant longer-term liquidity to selected banks according to criteria that were not publicly disclosed and not readily understood by the market. This week, the NBU again sold dollars to selected buyers at far below market rates, and it conducted another currency

auction on December 17 that, according to market participants, was not fully transparent, as several banks reportedly claimed that their bids had been excluded for reasons that the NBU would not specify. At a recent press conference, NBU Governor Volodymyr Stelmakh and Finance Minister Viktor Pynzenyk said interest rates would rise and liquidity would be curtailed, yet they gave conflicting statements on the nature and extent of planned rate hikes. We understand that the IMF is intending to write to the NBU and MOF to drive home the message that liquidity needs to be tightened, that interventions must be made more transparent and consistent, and that progress needs to be made on bank reconstruction.

¶5. (SBU) The NBU's actions raise more questions about governance, corruption, and behind-the-scenes deal-making. Major television programs are addressing the NBU's lack of capacity to handle the crisis as their number one news item. Business daily Profile has advertised its current edition on billboards across Kyiv by brandishing a picture of NBU Governor Volodymyr Stelmakh in a pose of dramatic shame. There is also a pervasive lack of trust in the banking sector. Raiffaisen Bank Aval, the country's second largest bank with an Austrian bank as its majority shareholder, has resorted to building-sized advertisements in central Kyiv, marketing high interest rates to bolster deposits and reign in withdrawals. Businesses and workers report to us, however, that Raiffaisen has held wage and other corporate payments for two or more weeks before transferring money to accounts. ING Bank has pressed orange clad teens into service, canvassing passers-by with offers of special deals for term accounts. We hear anecdotally that ordinary Ukrainians are withdrawing hryvnia deposits from subsidiaries of foreign banks, such as ING, in order to convert savings into dollars. The lack of available safe deposit boxes does not deter

most Ukrainians, who have a tradition of storing wealth under mattresses or beneath loose floor boards.

¶6. (U) Ukraine's economic crisis is getting very bad very quickly. The government reported a 14.4 percent month-on-month drop in GDP (from October to November), and a cumulative 2008 GDP decline from 5.8 percent (in January-October) to 3.6 percent (in January-November), reducing the overall GDP forecast for the year. The largest sector-based declines were registered in construction and energy (falling 16.1 percent and 3.6 percent, respectively, in January-November). Industrial production contracted 28.6 percent year-on-year in November (in October the decline constituted 20 percent). The steep fall in domestic and external demand, due to the plunging global commodity prices, sharp economic slowdown in major trading partners and frozen credit activity, has caused a severe contraction in all industries. The largest output fall in November was registered in export-oriented sectors, such as metallurgy, machine building and chemicals (declining 48.8 percent, 38.8 percent, and 35.2 percent year-on-year respectively).

¶7. (SBU) There are growing concerns about the sufficiency of the IMF program to plug Ukraine's 2009 financing gap. The Ukrainian government announced that external debt grew to $107 billion at the end of the third quarter of 2008. This figure could increase, if rating declines trigger technical defaults or loan calls with sovereign guarantees. In a December 16 discussion with us, the EBRD's Piroska Nagy said many foreign parent banks would fail to roll over debts owed by subsidiaries, contrary to a key IMF supposition in its SBA, and questioned whether the IMF's projected financing gap for 2009 of somewhat more than $10 billion is still accurate. According to Deputy Prime Minister Grigoriy Nemyria, who spoke with the Ambassador on December 17, Prime Minister Yulia Tymoshenko reportedly reached out to IMF Managing Director Dominique Strauss-Kahn on December 17 to discuss the IMF program in light of the worsening economic situation.

¶8. (SBU) Comment. Tied up in knots over policies that have all gone wrong, the NBU is failing to take the most rudimentary steps to reestablish trust in the hryvnia. The IMF is likewise stuck with more than its reputation on the line. The first $4.5 billion tranche has already been disbursed and roughly $12 billion awaits GOU action on key fiscal policy and banking sector reforms. IMF

officials recognize they tread a thin line. After speaking softly to journalists about the GOU's unsteady implementation of conditionalities last week, the IMF's Ceyla Pazarbasioglu privately expressed deep concerns about the deteriorating economic situation and poor policy making at the National Bank and the Ministry of Finance. Yet the IMF's overall criticism of the NBU policy response has remained mild. Despite perceived risks to market confidence, the IMF will likely need to come down harder on Ukraine to maintain credibility and increase the chance that its conditionalities will be fulfilled. Otherwise, were the next IMF tranche not disbursed, Ukraine will undoubtedly fail to meet external commitments, greatly increasing the odds of a true country-wide meltdown. End comment.

TAYLOR